



# Central Bank of Nigeria, Monetary Policy Department

Monetary Policy Series

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## HOW DOES THE MONETARY POLICY DECISIONS OF THE CENTRAL BANK OF NIGERIA AFFECT YOU? PART TWO

### THE INTEREST RATE EFFECT

The Central Bank of Nigeria (CBN) may decide to make a change in the Minimum Rediscount Rate (MRR). The MRR is the official interest rate of the CBN, which anchors all other interest rates in the money market and the economy. CBN's decision on the MRR affects the level of economic activities and prices in the country through a number of channels. The purpose of this brief is to examine how a change in interest rate by the CBN affects people and the economy. In subsequent series, we shall look at the effects of depreciating/appreciating the exchange rate on the people and the economy.

A decision by the CBN to change the MRR affects the market interest rate in different ways. When the Bank makes an announcement on the MRR, it affects the expectations of people and economic agents about the future direction of the economy. Such decisions also affect the prices of financial assets (like shares) and the exchange rate of the naira to other currencies as well as the ability of people and economic agents to save and spend money. For instance, when the interest rate is increased, people are encouraged to save instead of spend their money. An increase in interest rate would also lead to foreigners paying more to buy our local currency, thereby making foreign goods to be cheaper than goods produced in the country, and vice versa. This could encourage imports and discourages exports of goods and services. This has a limiting effect on our level of external reserves. Thus, when the CBN makes a change in interest rate, it affects the exchange rate. Although the change in exchange rate may directly affect domestic prices of imported goods and services, this effect may not be immediate. Also, the change in interest rate could generate an indirect effect on the prices of goods and services which compete with goods that are domestically produced or those goods and services that use imported raw materials. Consequently, a change in interest rate has effect on the component of the general price level of those goods that are imported and this affect all economic agents in the country. We can demonstrate these links using the chart below.

### HOW A CHANGE IN INTEREST RATE WORKS THROUGH THE ECONOMY



